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The Honorable Richard E. Neal
House Committee on Ways and Means
Subcommittee on Select Revenue Measures
United States House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

RE: Public Hearing on the Taxation of International Affiliate Reinsurance

Dear Chairman Neal and Ranking Member Tiberi:

On behalf of Swiss Reinsurance Company, I wish to submit comments to your July 14 hearing on the taxation of reinsurance between affiliated entities. Swiss Re strongly opposes any proposal to modify the taxation of international affiliate reinsurance. Reinsurance is critical to providing adequate and affordable insurance coverage to US consumers, especially those in disaster-prone areas. The centralization of capital and risk, not tax, are the primary considerations when arranging related-party reinsurance. The allegation such reinsurance provides significant tax incentives is incorrect. Finally, modifying the tax treatment of foreign reinsurance would increase the cost of insurance for consumers and businesses, reduce the availability of catastrophe insurance, destabilize the US insurance market, upset decades of U.S. tax and trade policy, is inconsistent with existing US tax treaty obligations and WTO commitments, which could spur retaliatory actions by other countries.

Foreign Reinsurance is Necessary for Adequate and Affordable Insurance Coverage for US Consumers

Global reinsurers rely on related-party reinsurance to increase underwriting capacity in local jurisdictions. Swiss Re is the second largest reinsurer in the world and the United States is by far our largest market. In order to increase the US underwriting capacity of its US-regulated subsidiaries, Swiss Re reinsures a portion of its nonlife business to its Swiss ultimate common parent. This is the model Swiss Re employs in all the countries in which it operates; it is also the model employed by most reinsurers around the globe. By aggregating capital and risk in Switzerland, Swiss Re subsidiaries significantly increase the amount of risks they can underwrite in their local areas. This translates into greater coverage at lower insurance costs for US consumers.

Foreign related-party reinsurance not only helps US consumers at the front-end when obtaining coverage, but also at the back-end when claims are paid. Because Swiss Re aggregates capital and risk in its common parent, that parent can, when a major catastrophe strikes, quickly and efficiently move cash directly where it is needed to pay claims. Absent related-party reinsurance, the parent would have to request distributions from its subsidiaries around the globe, await the necessary regulatory approvals, receive the distributions, and finally send the cash to the jurisdiction where it is needed to pay claims. Such an inefficient and time-consuming process would, in the event of a major US catastrophe, prove painful to US consumers at a time when help is needed most. Through the use of foreign reinsurance,

global reinsurers such as Swiss Re can help get cash to those consumers more quickly and efficiently so they can rebuild their lives, homes, and businesses.

Insurance Costs would Increase, Availability would Decrease

Raising taxes on reinsurance with affiliates would reduce the supply of insurance in the US property-casualty market. According to analysis by the Brattle Group, the net supply of reinsurance would decline by an estimated 20% as a result of the tax. With a decrease in amount of reinsurance available, insurance premium prices would rise., US consumers and businesses would have to pay an additional \$11-13 billion per year for insurance. The cost of catastrophe coverage would be especially impacted.¹ International reinsurers are critical for providing coverage of large-scale catastrophe risks, known as “peak risks,” such as California earthquakes and Gulf hurricanes. Because a major catastrophe has the potential to bankrupt primary insurers writing significant business in a disaster-prone region, insurers heavily reinsure these risks. For example, foreign insurers and reinsurers paid about 50% of \$41.1 billion of insured losses for hurricane Katrina, which were paid to cover 1.75 million claims.

An evaporation of reinsurance capacity would have major implications for the US property-casualty market. First, capital would be diverted from the US market unbalancing the global diversification of risk, which is necessary to cover major catastrophes, such as hurricanes. US reinsurers might increase market share, but a severe coverage gap is likely. As the private catastrophe coverage market dissipates, the Federal government would be forced to use taxpayer funds to cover the uninsured losses. For example, the three catastrophic hurricanes of 2005 (Katrina, Rita and Wilma) caused \$57 billion of insured losses, but more than \$200 billion in total economic damages. The federal government spent an estimated \$109 billion for disaster relief, plus more than \$8 billion in tax relief.

Centralization of Capital and Risk, not Tax, Drives Foreign Reinsurance

Insurance is a highly regulated industry, and thus where and to what extent a reinsurer decides to do business is driven primarily by regulatory and capital constraints. Tax concerns, while relevant, are almost always of secondary importance. In the context of foreign reinsurance, this is especially true given that the profitability of such reinsurance can not be known with certainty in advance; both income and losses are moved offshore. Swiss Re is a case in point: over the past decade, Swiss Re actually ceded net losses out of the US.

Affiliate reinsurance within US-based insurance groups allows a group of companies to pool and manage risks more efficiently. Thus, the group can write more business and underwrite larger risks than the separate companies’ capital would otherwise allow. Rating agencies recognize the value of affiliate reinsurance and take it into account when assessing the claims-paying ability of a US affiliate.

Moreover, tax is generally not a primary driver of foreign reinsurance because the ceded US business is generally subject either to the US federal excise tax or to a significant corporate income tax regime in a foreign jurisdiction. There is no great tax arbitrage opportunity for Swiss Re, for example, when it moves its US nonlife risks to Switzerland, a US treaty partner that imposes a significant income tax on its corporate residents.

H.R. 3424 is Technically Flawed and Violates Fundamental US Income Tax Principles and Treaties

The US has myriad trade and treaty agreements with jurisdictions throughout the world, agreements based on principles that have been crafted and refined over decades. As a foreign-based business providing a critical service to the US consumer and the US insurance industry, Swiss Re has been both a beneficiary of and an obligor under those agreements. Accordingly, Swiss Re is concerned that modifying the taxation of foreign related-party reinsurance could prove inconsistent with those trade and treaty

¹ Michael Cragg, J. David Cummins and Bin Zhou, “The Impact on the U.S. Insurance Market of H.R. 3424 on Offshore Affiliate Reinsurance: An Updated Economic Analysis,” July 8, 2010.

agreements that have worked well over the years to the mutual benefit of the US and foreign nations such as Switzerland.

Perhaps most importantly, the legislation violates the key principle underlying the US-Swiss income tax treaty and all similar tax treaties, namely, to avoid subjecting the same income to tax in multiple jurisdictions.² If a Swiss Re US insurance subsidiary reinsures risks with its Swiss parent, but is denied a US tax deduction for the associated premium, Swiss Re will pay double tax on the income – once in the US when received by the US company from the insured, and again in Switzerland when received by the Swiss company from the US company. Thus, the legislation generates double tax whenever a premium deduction is disallowed and the premium itself is subject to income tax in the foreign affiliate's local jurisdiction.

The legislation violates a second treaty principle – non-discrimination – that is explicitly incorporated in the US-Swiss and most other US income tax treaties. The attempt in the Technical Explanation of the Senate Finance Committee Staff Discussion Draft, which is nearly identical to H.R. 3424, to reconcile the proposal with the non-discrimination principle is unconvincing for several reasons. First, the argument that “the provision makes no distinction between foreign insurance companies on the basis of whether or not their reinsurance premium income is subject to tax in their residence country” is irrelevant; the issue is not whether the provision discriminates against a foreign company vis-à-vis another foreign company, but whether it discriminates against a foreign company vis-à-vis a US company.³ Second, the statement that “foreign corporations are in the same circumstances as tax-exempt entities because generally neither bears tax on reinsurance premiums from U.S. corporations” is incorrect. Foreign corporations such as Swiss Re pay a substantial income tax in their home jurisdiction on reinsurance premiums from U.S. corporations; by contrast, US tax-exempt entities do not pay any federal income tax (other than, e.g., UBIT) in their home jurisdiction. Finally, the assertion that “[t]he provision sets forth a standard for determining reinsurance premiums in an arm's length fashion” is untrue; the provision does nothing to ensure an arm's length price for reinsurance premiums. There is no economic correlation between disallowing a premium deduction based on an “Industry Fraction” and the appropriate price a US insurer should pay to its foreign affiliate for a particular block of reinsurance.

Regarding arm's length pricing, Swiss Re believes current US tax law already has the necessary tools to deal with “income shifting” by a US subsidiary to a foreign affiliate. The IRS has the authority under Code §482 to make adjustments necessary to prevent tax avoidance or evasion or to more clearly reflect income. In addition, rules specifically relating to related party reinsurance under Code §845 further allow the IRS to make adjustments to fully reflect the income of a US company. The American Jobs Creation of 2004 amended these related party reinsurance rules to further strengthen the IRS's authority to enforce arm's-length pricing in affiliate reinsurance contracts.

Regarding the proposal's use of “Industry Fractions,” Swiss Re believes they are an inappropriate metric for approximating an “appropriate” amount of affiliate reinsurance for global reinsurers. Each Industry Fraction effectively reflects the amount a typical US P&C insurer reinsures with non-affiliates; however, a global reinsurer such as Swiss Re is not a typical US P&C insurer. The Industry Fractions and “Premium Limitation” for the reinsurance business lines, for example, will almost certainly fail to reflect the difference in business models between a typical US P&C insurer and a global reinsurer.

The legislation's underlying premise that reinsurance is akin to earnings stripping is fundamentally flawed. Earnings stripping is generally effected by a company internally; reinsurance arrangements are subject to regulatory oversight and generally require state review and approval. Earnings stripping is generally ancillary to a company's core business and merely shifts income and expense streams within a

² The technical name of the US-Swiss treaty is “Convention Between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income” (emphasis added).

³ See United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, Art. 24 (“[T]he non-discrimination obligations of this Article apply only if the nationals or residents of the two States are comparably situated” (emphasis added)).

corporate group; reinsurance is a core business and shifts actual risks of loss between insurers within a corporate group. The tax benefit expected from earnings stripping is clear and generally quantifiable from the beginning; the tax benefit expected from a reinsurance transaction is not certain from the beginning, as it is unknown upfront whether a particular block of business will ultimately prove profitable. These fundamental differences strongly suggest that the legislation's approach to affiliate reinsurance is misguided and therefore likely to be tax inefficient and unnecessarily disruptive to the reinsurance market, with the resulting costs borne ultimately by US consumers and businesses.

Additionally, the legislation is overbroad, reaching many legitimate reinsurance transactions. Although the legislation allegedly targets business conducted in no- and low-tax jurisdictions, it fails to differentiate between these and high-tax jurisdictions. The legislation would subject all companies in non-US jurisdictions to identical restrictions and additional taxes, irrespective of the local tax rates.⁴ Further, the legislation gives no offsetting benefit to risk a foreign reinsurer cedes to a US insurer. Swiss Re currently has an ongoing and significant business arrangement with Berkshire Hathaway.

Finally, the legislation would penalize foreign-based reinsurance groups regardless of whether the reinsured business ultimately generated a net profit or a net loss. The legislation allegedly targets the shifting of profits overseas; however, as mentioned above, it is quite possible for business ceded overseas to generate losses. These factors strongly suggest the legislation's reach extends well beyond potentially abusive situations to overtly discriminate against all international reinsurance business attempting to operate in the US.

The Legislation Weakens US Competitiveness

From an economic perspective, tariffs and quotas such as those implicit in this legislation are the equivalent to a subsidy for domestic reinsurers and a tax on American insurance buyers. The legislation would have unbalancing effects on the US labor and product markets. There is a substantial risk of the loss of high-paying US jobs at foreign-owned reinsurers and insurers and allied service providers, affecting such diverse professionals as claims adjusters, actuaries, IT managers, accountants, lawyers, consultants and asset managers. These job losses would come on the heels of the 8.4 million US jobs lost in 2008 and 2009, of which less than 1 million were recouped in the first half of this year.

The bill would also make a diverse range of US businesses less internationally competitive by raising their cost of insurance. One group that would be especially impacted is US farmers, who would pay more for crop insurance, hindering their ability to earn a livelihood.

Higher crop insurance premium rates would discourage farmers from purchasing the coverage, undermining years of Congressional effort to promote crop insurance in lieu of ad hoc disaster assistance. In 2008, crop insurance provided \$90 billion in risk protection on 272 million acres, representing roughly 80% of the nation's acres planted for principal crops. This high participation rate means that crop insurance has become the principal vehicle for delivering assistance to farmers stricken by natural catastrophes. Given these concerns, imposing additional taxes and restrictions on reinsurance transactions is ill-advised and counterproductive.

In addition, given the extraordinary strains faced by the US financial system, it would be counterproductive to enact policies that impede capital flows in the reinsurance industry – one of the few areas of the financial services sector in which capital continues to flow freely. The legislation would

⁴ For reference, the average tax rate in the EU is about 25% and in Switzerland the statutory tax rate for Swiss Re is 21% (Federal and Zurich local taxes). According to a recent Ernst & Young study, American companies paid an average effective tax rate of about 23.7% in 2006. See Bloomberg.com news article, "Rangel Proposes Cutting Top Corporate Tax Rate to 28 Percent," (Nov. 14, 2008) (<http://www.bloomberg.com/apps/news?pid=20601087&sid=aVQ1EvAv3LU&refer=home>).

undercut efforts of insurance commissioners to promote the availability of coverage for key lines of business in their state by attracting reinsurers to their markets.

In closing, I would like to highlight Swiss Re's long history of service to the US and its citizens. For over a hundred years, Swiss Re has operated in the US and paid billions to its US insureds to rebuild lives, homes and businesses. Additionally, we employ nearly 2,500 employees in the US. Last year these employees received salaries from Swiss Re averaging \$114,900 per employee.

It is greatly hoped that the long and mutually beneficial relationship between Swiss Re and the US will continue for many years to come.

Sincerely,

Cosette R. Simon